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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 244

DEWEY SCHMOLL, Successor Assignee for the Benefit of Creditors of Murch Bros. Construction Company, and National Surety Corporation,

Petitioners,

vs.

THE UNITED STATES

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

Henry W. Nichols,
Bernard J. Gallagher,
M. Walton Hendry,
Attorneys for Petitioner.

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STATUTE

Section 3466, R. S., 31 U. S. C. Sec. 191 2

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 244

DEWEY SCHMOLL, Successor Assignee for the Benefit of Creditors of Murch Bros. Construction Company, and National Surety Corporation,

Petitioners,

vs.

THE UNITED STATES

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

The petitioners pray that a writ of certiorari be issued to review the judgment of the Court of Claims of the United States entered in the above entitled case on January 7, 1946.

Opinions Below

The opinion of the Court of Claims (R. 64) is not yet officially reported.

Jurisdiction

Judgment in the Court of Claims was entered January 7, 1946 (R. 72), and petitioners' and defendants' motions for new trial were overruled April 1, 1946 (R. 73). The

jurisdiction of this Court is invoked under Section 3(b) of the Act of February 13, 1925, as amended.

Questions Presented

1. Whether the equitable lien and the contractual rights of the National Surety Corporation, the surety on the contract bonds of the defaulted contractor, upon which bonds the surety has suffered substantial losses by payment of labor and material claims, entitles the surety to receive the balance of the contract price in the hands of the United States, without the United States first deducting therefrom, under the claimed authority of Section 3466 R. S., a sum to compensate the United States for capital stock taxes owed by the defaulted contractor, and for losses suffered by the United States under two contracts which were not covered by the bonds of National Surety Corporation.

2. Whether the Comptroller General has the right to deduct, under the claimed authority of Section 3466, R. S., taxes and other debts of the contractor, not related to the contract bonded, against the surety's interest in the contract price.

Statute Involved

The provisions of Section 3466, Revised Statutes, 31 U. S. C. 191, are quoted in the appendix, page 18.

Statement

Between November 18, 1933, and March 11, 1935, the contractor, Murch Brothers Construction Company, entered into 17 contracts with the United States for the construction of post office buildings in various parts of the United States. Petitioner, National Surety Corporation, executed bonds conditioned for the performance of these 17 contracts and the payment of labor and materials, pursuant to the

Act of August 13, 1894, amended February 24, 1905, known as the Heard Act. The contractor defaulted under these contracts after completing a large part of the work and the United States thereupon took over and completed the work (R. 35). After deducting from the original contract prices all expenses of completing the 17 contracts there remained in the hands of the United States a balance of contract funds in amount of $22,505.01.

The National Surety Corporation, as surety on all 17 contracts, paid all outstanding claims of labor and materialmen left unpaid by the contractor, and suffered a loss thereby of $202,011.66 (R. 47). The Court of Claims, however, in rendering judgment in the surety's favor, offset against the balance of $22,505.01 referred to, the sum of $2,552.43, the cost of correcting defective work under two contracts (not included in the 17 contracts mentioned above) which the contractor had with the United States through the Veterans' Administration. The National Surety Corporation was not the surety on those two Veterans' Administration contracts and was not a party to any of the transactions in relation thereto (R. 46).

The Court of Claims further offset against the balance of $22,505.01, the sum of $206.53, unpaid capital stock tax assessed for the year 1935 against the contractor, making a total offset of $2,758.96 against the said balance (R. 47-48). It is contended by the surety that these two deductions were improper as a matter of law.

Specifications of Errors To Be Urged

The Court of Claims erred:

1. In not recognizing that the National Surety Corporation had an equitable lien upon the balance of the contract price in the hands of the United States, which equitable lien, under the decisions of this Court, the Federal Courts

and the Court of Claims, was superior to any claims of the United States as a creditor of the contractor.

2. In not recognizing that the United States owed a contractual duty to the surety, not to vary the terms of the suretyship contract by diverting part of the contract price to the payment of debts of the principal not covered by the bonds.

3. In not recognizing that the surety, by reason of its payment of labor and material bills owed by the defaulted contractor, became subrogated to the rights of the labor and materialmen, and to the equitable lien which they have in their own right, as well as to the rights of the United States, in the balance of the contract price.

4. In holding that the United States had the right to deduct from the balance of the contract price in its hands an item of $206.53 capital stock tax owed by the defaulted contractor, as against the interest of the surety who has paid the contractor's labor and material men.

5. In holding that the United States had the right to deduct an item of $2,552.43 from the balance of the contract price in its hands, against the interest of the surety who has paid the contractor's labor and materialmen, which item represented a loss by the United States on two contracts of the defaulted contractor bonded by sureties other than National Surety Corporation was not the surety.

6. In not recognizing that the balance of the contract price was not a part of the assets of the contractor, and therefore, Section 3466 of the Revised Statutes gave the United States no right to said balance against the property right therein of the surety.

7. In not recognizing that the liability of a surety on a Government contract bond extends only to the performance

of that particular contract and to the payment of labor and materialmen thereon.

Reasons for Granting the Writ

The bonds involved in this case are typical of those required on all Government contracts. The Comptroller General in recent years has made a practice of deducting from contract balances in the Government's hands, taxes and other debts of the contractor, not related to the contract bonded, but owing to the United States by the defaulted contractor, in cases where a surety has either completed a contract defaulted by the contractor or paid the labor and material bills left unpaid by the contractor. The Comptroller General claims the authority to make such deductions under Section 3466 R. S. (Appendix p. 25).

The Court of Claims, in the case of *Maryland Casualty Company* v. *United States,* 100 C. Cls. 513, held that the United States could not offset taxes owed by the contractor against the contract balance, against the surety's interest in the money. The Court of Claims then held, in the instant case, that the United States could make such an offset where the surety had suffered losses under its *payment* bond, but did not decide what the situation would be if the surety's loss had been under its *performance* bond. The result of this conflict is that the Comptroller General refuses to follow the *Maryland Casualty Company* case, stating his position in Case No. B-41334, dated April 18, 1946, to be:

> "This office does not consider the holding in the Maryland case a controlling precedent with respect to the right of subrogation of a surety to amounts otherwise due from the United States, as against the right of the Government, to set off, out of such funds, moneys due from the surety's defaulting principal.
>
> • • • • • • •
>
> While the General Accounting Office accords 'persuasive weight' to the decisions of the Court of Claims

and of other inferior Courts, only decisions of the Supreme Court are considered binding."

The question involved, therefore, in its essence, is whether the surety on performance and payment bonds can, in effect, be made to pay the debts of the contractor to the United States for taxes, or for any other debts, not related to the project which the surety bonds.

In the instant case, the amount of the debts of the contractor deducted by the Government is small, but if the Court of Claims' interpretation of Section 3466 Revised Statutes is correct there is no limit to the character or amount of the contractor's debts that can be charged against the surety's interest in the contract price. As an illustration, a contractor may owe no taxes to the Government at the time of execution of the bond and contract but after his income tax report is audited by the Government, he might be assessed with a large deficiency; no surety could or would anticipate this hidden liability when it wrote the bond. The consequences of the decision of the Court of Claims in the instant case, and the present ruling of the Comptroller General, are far reaching and involve an interpretation of Section 3466 never heretofore placed upon that section and never intended to be placed on that section.

The surety, in consideration of writing performance and payment bonds, looks to its equitable lien and right of subrogation to the equitable rights of labor and materialmen, and its subrogation to the rights of the United States, to insure that the full contract price agreed to be paid by the United States will be available to complete the work, and to reimburse the surety for its payments to labor and materialmen. This will not be so if the Comptroller General has the right, under R. S. 3466, to deduct miscellaneous debts, taxes and others, from the balance of the contract price in the Government's hands.

The Comptroller General takes the position that he will be bound only by a decision of the Supreme Court on this important subject.

It will be seen, therefore, that: (1) *the Court of Claims has decided an important question of Federal Law which has not been but should be settled by this Court;* (2) *its decisions in the Maryland Casualty case and the instant case are conflicting, leaving in doubt an important question of Federal law;* (3) *the decision of the Court of Claims relates to the construction of a statute of the United States, R. S. 3466, which has not been but should be settled by this Court.*

The surety who has paid labor and material claims under its bond has an equitable lien attaching to the contract price, which lien is superior to the claim of the United States as a general creditor for taxes and other debts owed it by the defaulted contractor

The landmark case delineating the equitable rights of a surety when, after the contractor's default, it fulfills the obligation of its bond, is *Prairie State Bank* v. *United States,* 164 U. S. 227. This case originates the doctrine of the equitable lien arising in favor of the surety who answers for the debt, default or miscarriage of another, which equitable lien attaches directly to the balance of the contract price remaining in the hands of the obligee, relates back to the date when the surety made its bond, and is superior to the claims of any creditor, including the United States. Hereafter the superiority of the surety's equitable rights, thus defined, over the unsecured claim of the United States for taxes and other debts owed by the contractor, asserted under Section 3466, Revised Statutes, will be shown.

The doctrine of the *Prairie State Bank* case has been followed consistently in all the courts.

In *Farmers Bank* v. *Hayes, et al.*, 58 F. (2d) 34 (C. C. A. 6), that court said:

> "This is on the principle that a surety who gives bond to the owner to insure performance of a building contract by the contractor's is subrogated to the rights of the *owner* in the percentage which the owner retains as security for the performance of the contract; that when the contractor performs his obligation to the owner, but fails to pay labor and material men, and the surety is subrogated to liens of laborers and material men upon the fund reserved by the owner."
>
> "*Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404; *Belknap Hardward Manufacturing Company* v. *Ohio River Contract Company*, 271 Fed. 144; *Exchange State Bank* v. *Federal Surety Company*, 28 Fed. (2d) 485 (C. C. A. 8)."

The retained portion of the contract price is as much for the benefit of those furnishing labor and material as it is to insure performance of the work, and the surety, upon payment of the claims of labor and material men becomes subrogated to their rights in the balance of the contract price.

In the instant case, the Court of Claims advanced a theory that is directly in conflict with the cases just cited, with the *Maryland Casualty Company* case, 100 C. Cls. 513, as well as with other Federal cases referred to below.

The theory is that inasmuch as the plaintiff only paid *material* bills, whereas the money withheld by the United States was to secure *performance* but was not withheld to insure payment to laborers and materialmen, the surety had no right to that part of the contract price, since it

> "* * * was not retained to secure performance of the obligation the surety discharges."

Compare this point of view with the *Farmers' Bank* case, as follows:

> "But whether in the instant case the surety's rights arise out of subrogation to the rights of the Board of Trust (the obligee) or of the equitable liens of the laborers and materialmen, the result is the same. In either case, the equitable rights of the surety become fixed as of the date of the bond, and are superior to those of any holder of any after acquired lien. Whether the lien of the surety extends only to the reserved percentage under the contract, or also to sums earned under the contract, and retained by the owner, is a question which has frequently been raised. We think it is now settled that it extends to both."

The cited case held, plainly enough, that the surety's right is an equitable lien which attaches to the *contract price*, and became fixed as of the date of the bond.

Compare, furthermore, the Court of Claims' langauge in the instant case, that the contract money

> "• • • was not retained to secure performance of the obligation the surety discharges."

with the court's own language in the *Maryland Casualty* case, 100 C. Cls. 513, 522,

> "• • • But when the surety pays the laborers and materialmen, it is performing the contract as much as when it completes the building. We see no more reason why the parties should intend that, either under the guise of building the building, or of paying laborers and materialmen, both of which the surety has promised will be done, it should in reality, and because of the ease of bookkeeping, be paying the contractor's taxes or other debts, which it has not promised will be done."

Also:

> "We construe the bond and the transaction as a whole as implying a promise on the part of the Govern-

> ment to the surety that it will not so settle the accounts of the contractor as to leave the surety in the position of paying the contractor's taxes."

This brings into sharp focus the conflict in the Court of Claims.

It certainly is a novel proposition of law that a surety may have an equitable lien in the contract price when it loses under its performance bond but not when it loses under a payment bond. In the instant case, incidentally, the distinction between performance bond and payment bond does not exist because the bonds actually involved are *performance* bonds given under the now repealed Heard Act. There are no *payment* bonds, as such, involved in this case.

This Court reached the conclusion in *Martin* v. *National Surety Company,* 300 U. S. 588, pages 597, 598, • • •

> "That the failure to pay materialmen was a default of such a nature as to impose a duty on the contractor to turn over the payments to the surety upon appropriate demand. There is argument to the contrary. According to that argument, the moneys were to be assigned in the event of default in the performance of the contract between the contractor and the Government, and not upon failure to pay persons other than the Government who had claims against the contractor for materials or labor. But the statute directs that a bond for the prompt payment of materialmen and laborers shall be executed by the contractor before the commencement of the work. Not only that, but the contract with the Government, which was drawn in the standard form, is a confirmation and adoption of the statutory duty. The terms of the bond are read into the contract, and there is default under the contract when there is default under the bond."

In *United States Fidelity and Guaranty Company* v. *Sweeney*, 80 F. (2d) 235 (C. C. A. 8) the court said:

> "• • • Laborers and materialmen, however, have an equitable right to payment from funds due a contractor on a public improvement, in preference to general creditors. Belknap Hardware and Manufacturing Company *v.* Ohio River Contract Co. (C. C. A. 6), 271 Fed. 144. The statutory requirement of a bond to protect them is not inconsistent with such equitable rights. American Surety Co. *v.* Westinghouse Elec. Mfg. Co., (C. C. A. 5), 75 Fed. (2d) 377. There is a recognized equitable right of unpaid furnishers of labor or materials to such part of the contract price as may remain in the possession of the Government after the completion of the work by the contractor. Riverview State Bank *v.* Wents, (C. C. A. 8) 34 Fed. (2d) 419; Henningsen v. United States Fidelity and Guaranty Co., 208 U. S. 404, 28 S. Ct. 389, 52 L. Ed. 547; Farmers' Bank *v.* Hayes (C. C. A. 6), 58 Fed. (2d) 34; American Surety Co. *v.* Westinghouse Elec. Mfg. Co. (C. C. A. 5), 75 Fed. (2d) 377.
>
> "Appellant was bound by contract to pay the claims for labor and material, and upon paying these claims it was entitled to be subrogated to the superior equities of the laborers and materialmen, and when payment was made, its rights related back to the time of making the contracts. Prairie State Bank *v.* United States, 164 U. S. 227, 17 S. Ct. 142, 145, 41 L. Ed. 412; Henningsen *v.* United States Fidelity and Guaranty Co., 208 U. S. 404, 28 S. Ct. 389, 52 L. Ed. 547; London and Lancashire Indemnity Co. *v.* Endres (C. C. A. 8) 290 Fed., 98; in re: Scofield Co. (C. C. A. 2), 215 Fed. 45; Farmers' Bank *v.* Hayes (C. C. A. 6), 58 Fed. (2d) 34."

In *Morgenthau, Secretary of the Treasury, et al.* v. *Fidelity and Deposit Company of Maryland*, 94 Fed. (2d) 632, 68 App. D. C. 163, the surety claimed the balance of the contract price.

> "By subrogation on account of the money paid out by it to complete the contract and discharge the claim,

> the Court held that the surety's advance to the contractor and its payment to the laborers and materialmen released the contractor from his obligations under the contract and, as this Court said in Henningsen *v.* U. S. F. and G Company, 208 U. S. 404, likewise released the Government from all equitable obligations to see that the laborers and supplymen were paid. The surety thereby becomes subrogated to the equity of the United States. Its action created in itself an equitable right which entitled to demand and receive the balance due from the United States, and this equitable right, as this Court said in Prairie State Bank v. U. S., 164 U. S. 227, arose from and related back to the date of the original contract of suretyship. * * *"

The authorities cited above demonstrate conclusively the unassailable right of the surety to the contract price.

The true nature of the right of the unpaid materialmen to the contract price, and the equitable obligation owed them by the United States to apply the contract price in their favor is shown by *Philadelphia National Bank* v. *McKinlay,* 72 Fed. (2d) 89 (U. S. App. D. C.). This was a suit in equity by those who had furnished labor and material to a Government contract, the purpose of which suit was to *secure from the Government* the balance of the contract price for distribution among them.

The Court held that the balance of the contract price:

> "* * * Is earmarked with the claims of all persons furnishing supplies and labor on the contract, and this is true because, *irrespective of the statutory bond, those persons who furnish labor and do work on a Government project have an equitable lien on the fund for the payment of their work and labor* until the fund is paid to the contractor" (Italics supplied).

This case shows that the retained part of the contract price is withheld by the United States just as much for the

protection of laborers and materialmen as to insure performance of the contract work. This case is a direct answer to the Court of Claims' position in the instant case that the retained amount

> "• • • was not retained to secure performance of the obligation the surety discharges."

namely, payment of the claims of laborers and materialmen.

The surety is a party to the contract with the United States and has a legal right in addition to his equitable lien, to receive from the United States the balance of the contract price

In *Martin* v. *National Surety Company*, 300 U. S. 588, this Court said that the terms of the bond are read into the contract, and there is default under the contract when there is default under the bond. This authority shows clearly the legal status of the surety as a party to the contract entitled to receive the balance of the contract price after default of the contractor.

It is well settled that there are reciprocal obligations, moving between the surety and the obligee, the United States in this case, proving the existence of a contract on the part of the United States to the surety that the United States will do nothing to injure or impair the surety's rights under the suretyship agreement.

The bonds in the instant case were conditioned for the performance of the work and payment of labor and material bills. Therefore, the only obligations assumed by the surety were these two.

The reciprocal obligation of the United States was to see that the contract funds were applied to the construction of the building, which necessarily included payment of labor and material bills. This obligation prevented the

United States using the contract money for any other purpose. As this Court said in *American Surety Company* v. *Greek Catholic Union,* 284 U. S. 563,

> "It (the Greek Catholic Union) cannot now ask that the bond be rewritten to cover an event not therein specified or contemplated."

The payment by the United States, out of the contract money, of the debts of the contractor for taxes and losses on other contracts not bonded by National Surety, was not contemplated by the parties when the bonds were written, and was a clear violation of the Government's contractual obligation to the surety not to divert the contract funds for any other purpose than intended by the parties.

In *American Surety Company* v. *Greek Catholic Union, supra,* this Court further stated:

> "Where an insured undertakes to substitute a new obligation—thus substituting a new and different liability from any undertaken in the instrument of suretyship and depriving the insurer of the right of subrogation, such conduct operates to discharge the obligation of the indemnity contract."

In the instant case, the United States, by diverting the contract funds to the payment of debts of the principal on other contracts, and taxes due the United States, was clearly substituting a "new and different liability from any undertaken in the instrument of suretyship," and deprived the petitioner of the right of subrogation.

There was nothing in the bonds in this case which required petitioner to pay the debts of its principal for which the Government made deductions.

United States v. *Hodge,* 6 How. 279, states that the principle on which suretys are released,

> "Is founded upon the restriction of the rights of the suretys by which they are supposed to be injured."

The diversion of the contract funds to pay debts of the principal not covered by the bond, was an injury to the surety. By such action the surety was deprived of his right of subrogation to these funds.

Had the surety, upon default of the contractor, completed the contract work, there is no doubt that it would have had the right to recover from the United States the money so earned. The Court of Claims said, in the *Maryland Casualty Company case,* 100 C. Cls. 513:

> "But when the surety pays the laborers and materialmen, it is performing the contract as much as when it completed the building. We see no more reason why the parties should intend that, either under the guise of building a building, or of paying laborers and materialmen, both of which the surety has promised will be done, it should in reality, and because of the ease of bookkeeping, be paying the contractor's taxes or other debts, which it has not promised will be done."
>
> "We construe the bond and the transaction as a whole as implying a promise on the part of the Government to the surety that it will not so settle the accounts of the contrator as to leave the surety in the position of paying the contractor's taxes."

The Court also said in that case:

> "We think that in no case is it intended that the surety transaction should work out in such a way that the surety has paid the contractor's taxes or unrelated debts to the Government."

It is clear from the above, that the Court of Claims recognizes the contractual obligations flowing from the United States to the surety, not to vary the terms of the contract, or to impose upon the surety any obligation greater than contemplated by the bond.

This case also illustrates the point that where the surety pays the labor and material bills, instead of taking over and

completing the work, the rule is the same; since in taking over and completing the work, the surety would be required to pay labor and material bills.

Inasmuch as it is perfectly clear that a contract exists between the United States and the surety, which obligates the United States not to vary the terms of the contract between it and the surety, by diverting the contract funds to other purposes, Section 3466, R. S., has no application whatsoever in the instant case. Because of the contractual relationship, between the United States and the surety, the contract funds are in a different class than any other funds, and, therefore, are not subject to the provisions of Section 3466, R. S.

The Surety is Subrogated to the Rights of the United States

The surety making payment under its bonds is subrogated to the rights of the United States. *Farmer's Bank* v. *Hayes, et al.*, 58 Fed. (2d) 34 (C. C. A. 6). *Morgenthau* v. *Fidelity and Deposit Company*, 94 Fed. (2d) 632, 68 App. D. C. 163.

The equitable claim of the materialmen, to which the surety is subrogated, is superior to the claims of general creditors. *U. S. F. and G. Company* v. *Sweeney*, 80 Fed. (2d) 235 (C. C. A. 6).

The claim of the United States for taxes owed by the contractor is subordinate to the surety's property right in the contract price

This Court has never decided a case wherein the United States has asserted, under the claimed authority of Sec. 3466 R. S., the right to offset against the balance of the contract price due the surety, miscellaneous debts, including taxes, owed by the contractor in default. Some recent lower court cases on the point, however, are helpful.

In re Van Winkle, 49 F. Supp. 711 (D. C. W. D. Kentucky, 1943), the contractor completed the building but failed to pay certain bills for labor and materials. The surety paid the claims, but not before the United States had filed a lien for taxes due by the contractor. Both the surety and the United States claimed the fund in the hands of the owner, the United States claiming under Section 3466, R. S. The Court recognized the surety's equitable lien and decided in its favor.

In *New York Casualty Company* v. *Zwerner,* 58 Fed. Supp. 473 (D. C. N. D. Ill. E. D.), the contractor defaulted in the payment of labor and material bills, which the surety paid. The Collector of Internal Revenue filed a lien against the National Housing Agency, to attach the final payment in its hands. The Court held the surety entitled to the money ahead of the Collector of Internal Revenue, saying:

> "The tax Collector by his notice of lien and levy can have a lien only upon funds due to the contractor and, since labor and material claims, and possible other claims, as heretofore set forth, will absorb more than the balance due the contractor on said construction contract, there is no fund upon which the tax collector's lien or levy can attach. This suit does not put in issue the amount of the taxes or the propriety thereof, but seeks simply to prevent the taking of money belonging to the plaintiff to pay the taxes of someone else."

See also *Heintzelman Construction Company,* 34 Fed. Supp. 109 (D. C. W. D. N. Y.), where the Collector of Internal Revenue had filed a claim with the trustee of the bankrupt contractor. The court directed the trustee in bankruptcy to apply the contract money to the payment of various claims for material furnished and labor performed for such work, holding that as to a claim of the United

States for social security tax, its priority rights under the Bankruptcy Act are limited to priority as between creditors of the estate, and that the contract fund was a *trust fund* and never became part of the estate.

The unsecured claim of the United States under Section 3466 R. S. is inferior to the property rights of the surety in the balance of the contract price

The authorities cited above establish beyond question that the surety has been granted the special protection of equity in return for having fulfilled its undertaking to answer for the debt, default or miscarriage of its principal, the defaulted contractor. Equity has granted the surety a lien, which is a property right in the balance of the contract price remaining in the hands of the Government. Each and every claim of the Government under the contracts bonded by the National Surety Corporation in this case has been satisfied. The two claims setoff, i. e., the tax claim for $206.53, did not arise until after the surety made its bonds and has no relation to the contracts bonded, and the claim for $2,552.43 arose under two Veterans' Administration contracts which were bonded by a surety other than National Surety Corporation. These claims bonded by another surety cannot be charged against the plaintiff. *United States Fidelity and Guaranty Company* v. *United States,* 92 C. Cls. 144.

There can be no doubt from the authorities cited that the law is well settled that the surety has an equitable lien upon the contract monies. The Government has no lien, legal or equitable. *United States* v. *Oklahoma,* 261 U. S. 253; *United States* v. *Giger,* 26 Fed. Supp. 624 (D. C. W. D. Ark); *United States* v. *Griswold,* 8 Fed. 496, 500 (Cir. Ct. Oregon). The claim of the United States to the asserted priority rests exclusively upon the statute. No lien is

created by it. It does not overreach or supersede any bona fide transfer of property in the ordinary course of business. While the United States has a priority on claims for taxes, such priority is in the assets of the estate, and it does not give priority over a valid lien. *United States Fidelity & Guaranty Company* v. *Sweeney,* 80 Fed. (2d) 235. The priority of the United States does not reach back over any valid lien, whether it be general or specific. *United States* v. *Sheriff of Charleston* (D. C. S. C.), Fed. Cas. No. 16276. Section 3466 does not give a lien to the United States; therefore, if a lien in favor of a third person has arisen before the right of the United States to a benefit has accrued the property is divested out of the owner, and cannot be made liable to the United States. *Lerman* v. *Lane Novelty Company,* 130 N. J. Eq. 141,21 Atl. (2d) 827. The United States has no lien in any event by virtue of Section 3466. *New York Casualty Company* v. *Zwerner,* 58 Fed. Supp. 473.

The United States is an unsecured creditor of the same class as unsecured creditors generally, though within its class it has the priority of payment given it by Section 3466 R. S. It now claims that this priority in such class of unsecured creditors elevates it to and above the higher level of the surety, which is secured by its equitable lien attaching to the contract money. But this literally would be lifting oneself by one's own bootstraps.

Even if the Government had a lien for its taxes under Section 3466 there is no property of the contractor to which the tax lien could attach

In the case of *F. H. McGraw Company* v. *Sherman Plastering Co., et al.* 60 Fed. *Sup.* 504, the United States District Court for Connecticut held that since the amount owed by the subcontractor to its materialmen exceeded the bal-

ance due it on the contract price, the subcontractor had no "right of property" in the unpaid contract, to which the Government's claimed lien for taxes could attach; that merely by assertion of the lien the rights of the Government rose no higher than those of the taxpayer whose right to property is sought to be levied on.

Where there is a default by the contractor, either in performance or in non-payment of laborers and materialmens' bills, the contractor has no property right in the unpaid balance of the contract price and therefore there is nothing against which a priority in favor of the United States can be claimed. *F. H. McGraw,* supra. *In re Van Winkle,* supra. *United States Fidelity & Guaranty Company* v. *United States,* 92 C. Cls. 144; *Martin v. National Surety Co.,* 300 U. S. 588; *In re Duncan,* 127 Fed. (2d) 640 (C. C. A. 3); *Karno-Smith v. Maloney,* 112 Fed. (2d) 690 (C. C. A. 3).

Since the surety is entitled to equitable as well as contractual subrogation in the contract price, it is plain that upon default the contractor had no right, title, or interest in such fund and therefore was without authority or power to assign the same. It could not deprive the surety of its right by an assignment. The defendant would have no right of priority with respect to moneys which its debtor had no right to assign since Sec. 3466 applies only to the assets of the debtor in the hands of its legal representative. *United States v. Oklahoma,* 261 U. S. 253.

Priority claims of the United States under Sec. 3466 are subordinate to the lien of a mortgage which has attached before the indebtedness to the Government accrues. *United States v. Guaranty Trust Co.,* 33 Fed. (2d) 533. C. C. A. 8)

The tax claim in the instant case was for the year 1935. The contracts involved were dated from November 18, 1933

to March 11, 1935. The tax did not accrue until after the date of the last contract. In connection with a possible assertion by the Government that it had a lien for the 1935 capital stock tax, it should be noted that on the Schenectady contract alone, Case No. 44999, where the contract is dated November 18, 1933, the surety had a loss of $45,754.49 (R. 341), which exceeds the total recovery in the Court of Claims plus the item of tax deductions and the charge for losses on other contracts. This contract was made more than a year before the year of the capital stock tax.

The right of the surety to receive the balance of the contract price is superior to the right of the defaulted contractor's assignee or trustee in bankruptcy

As this Court said in *United States* vs. *Oklahoma, supra,* the priority afforded the United States under Section 3466 attaches only to the assets in the hands of the insolvent debtor's legal representative. Therefore, the claim of the United States under Section 3466 must, in any event, be contingent upon the right of the assignee or a trustee in bankruptcy to receive the balance of the contract price in the fact of a claim by the surety who has performed under its bond.

In the case of *Lyttle* vs. *National Surety Company,* 44 App. D. C. 1936, there was an unexpended balance of the contract in the hands of the United States, and a contest arose between the surety who had paid the material bill, and the trustee in bankruptcy of the contractor for the fund. The Court, in awarding the money to the surety company, said:

> "The surety company, having a valid, equitable lien on this fund and being subrogated to the rights

> of the government to the extent of being reimbursed for the amount advanced under its obligation as surety, it is not clear just what claims could be asserted by the trustee to have the matter adjudicated in the bankruptcy court. The lien of the surety company against this fund was prior and superior to any claim shown to exist against the contractor or the trustee standing in his shoes. As against the contractor and likewise against the trustee, the equity which existed in favor of the surety existed not from the date of the bringing of the present suit but from the date of the bond."

In a very recent case, that of *California Bank* vs. *United States Fidelity and Guaranty Company*, 129 Fed. (2d) 751, (C. C. A. 9), decided July 27, 1942, which involved questions concerning the surety's right to subrogation upon a building contract with the Government, the court, in the course of its opinion, stated as follows:

> "Thus, in consequence of Anderson's (Anderson was the contractor) default, the $37,170.04 then in the hands of the United States became a fund which the United States was entitled to apply to the payment of materialmen's claims, and which appellee, as subrogee of the United States, was entitled to have applied in reimbursement of the $21,609.28 expended by it in paying such claims; and appellee's right to have the fund so applied *was superior to any right of Anderson or Anderson's assignees—if any.*" (Italics supplied.)

Other cases holding that the right of the surety is superior to the right of the defaulted contractor's assignee or trustee in bankruptcy are:

National Surety Co. v. *Lane*, 45 App. D. C. 176;
Philadelphia Bank v. *McKinlay*, 63 App. D. C. 296, 72 F. (2d) 89;
Moran v. *Guardian Casualty Co.*, 64 App. D. C. 188, 76 F. (2d) 438.

The Court of Claims in mis-applying Section 3466 put the United States, a general creditor, ahead of the surety, secured by a lien, which gave it a property right in the balance of the contract price. This is patently wrong because if it were good law any general creditor would have the same right, subject only to the priority of the United States. The priority does not elevate the United States out of this unsecured class. Despite its priority *within its class*, it still is subordinate to persons in higher legal relationship to the contract money.

The Court of Claims made reference to *United States* vs. *National Surety Company*, 254 U. S. 73, as supporting the position taken in this case. That case is not at all in point. That was a case where the bond penalty was only $3,150.00 whereas the Government's loss because of the contractor's default was $13,000.00. Payment by the surety of the full penalty of the bond left the United States with an unpaid loss of $9,850.00 on the contract bonded. It always has been the law that the surety's equitable lien does not attach where the loss of the obligee *on the contract bonded* is not satisfied in full by the surety. But that is not to say that the United States has the right, after it has been paid in full its loss on the contract bonded, to charge against a surplus of the contract price the collateral and unrelated debts owed by the contractor to the United States. The Court of Claims said in categorical language in the *Maryland Casualty Company case, supra*, that the United States did not have the right to offset taxes or unrelated debts of the contractor against the interest of the surety.

Conclusion

The question is one of importance. It involves the rights of surety in every case where the defaulted contractor is indebted to the United States for taxes. Such cases will

occur in increasing numbers in the future and will directly affect the surety industry. It is respectfully submitted that the decision below marks a distinct departure from the rationale of similar cases decided in its own court and in this Court, and should, therefore, be reviewed.

For the reasons stated, it is respectfully submitted that this petition should be granted.

HENRY W. NICHOLS,
BERNARD J. GALLAGHER,
M. WALTON HENDRY,
Attorneys for Petitioner.

APPENDIX

Section 3466, R. S., 31 U. S. C. Sec. 191, reads as follows:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

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711692—46

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 244

DEWEY SCHMOLL, SUCCESSOR ASSIGNEE FOR THE BENEFIT OF CREDITORS, ETC., AND NATIONAL SURETY CORPORATION, PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (R. 64–72) has not yet been reported.

JURISDICTION

The judgment of the Court of Claims was entered on January 7, 1946 (R. 72). Motions for a new trial filed by petitioners and respondent were overruled on April 1, 1946 (R. 72–73). The petition for a writ of certiorari was filed on June 28, 1946. The jurisdiction of this Court is invoked

under Section 3 (b) of the Act of February 13, 1925, as amended by the Act of May 12, 1939.

QUESTION PRESENTED

Whether in a suit for the balance due on certain construction contracts, brought by the insolvent contractor's assignee and the surety who had satisfied all labor and material claims, the United States, by virtue of R. S. 3466, is entitled to offset debts due the United States by the contractor for (1) capital stock taxes, and (2) for correcting defective work under two separate contracts on which there had been a different surety.

STATUTES INVOLVED

The relevant portions of the statutes involved are set forth in the Appendix, *infra*, pp. 12–13.

STATEMENT

Between November 19, 1933 and March 19, 1935, Murch Brothers Construction Co., Inc. (the "contractor"), entered into 17 contracts with the United States for the construction and remodeling of post offices (R. 32). National Surety Corporation (the "surety"), a petitioner herein, became surety on the payment and performance bonds furnished to the United States pursuant to the Act of August 24, 1935 (Appendix, *infra*, pp. 12–13) (R. 34). On June 22, 1935, due to lack of funds, the contractor suspended work on the contracts (R. 34). On June 27, 1935, the United States terminated the contractor's right to proceed, and

let contracts to others for the completion of the work (R. 35). On January 3, 1936, the contractor made an assignment for the benefit of its creditors (R. 32). The surety paid labor and material claims totaling $202,011.66, and it was agreed between the surety and the successor assignee for the benefit of creditors (the petitioners herein) that the surety was entitled to be subrogated for that amount (R. 47). After deducting the total amount which the United States paid to the contractor and to the completing contractors, there remained an unpaid balance of $55,197.57 of the total of the contract prices (R. 47). From this balance, the General Accounting Office deducted: (1) $31,547.80 as expenses incident to the contractor's default, (2) $2,552.43 for correcting defective work done by the contractor on separate Veterans' Administration contracts upon which the National Surety Corporation had not been surety, and (3) $206.53 for capital stock taxes which the contractor owed the United States—a total deduction of $34,306.76 (R. 48). The General Accounting Office then suspended payment of the acknowledged balance because of its uncertainty as to the person to whom payments should be made (R. 37). Thereafter, petitioners instituted eleven suits in the Court of Claims to recover $64,175.83, for the balance allegedly due on the contracts, for damages from delay allegedly caused by the United States, and for work per-

formed under protest by the contractor (R. 1–11). The United States filed a general traverse in each case, and, by order of the court, the cases were consolidated (R. 27, 32). On April 5, 1944, the United States filed a counterclaim for the items deducted by the General Accounting Office (R. 27–31), and petitioners filed a replication thereto (R. 27–31). After a trial on the merits, the Court of Claims entered Special Findings of Fact and Conclusion of Law, sustaining the deductions made by the General Accounting Office, but awarding judgment, in favor of the surety, for $30,015.58, of which $9,124.77 was for damages for delays caused by the Government, and the remainder for the net balance due on the contracts (R. 32–64, 69–72).

ARGUMENT

Contrary to petitioners' contentions, the question here presented is a narrow one. The only problem is whether, where an insolvent debtor has made an assignment for the benefit of creditors, the priority in payment conferred on a debt due the United States takes precedence over a claim to unpaid contract balances made by a surety who has paid claims for labor and material. Section 3466 of the Revised Statutes provides that: "Whenever any person indebted to the United States is insolvent * * * the debts due to the United States shall be first satisfied" (Appendix, *infra*, p. 12). The court below held

that the contractor herein, having made an assignment for the benefit of its creditors, had manifested its insolvency in a manner covered by the statute (*United States* v. *Emory,* 314 U. S. 423, 426); that the claims of the United States for capital stock taxes and for correcting defective work under other contracts were entitled to priority over the claim of the surety; and that such claims might be offset against the contract balance withheld by the Comptroller General. In so holding, we submit that the court below was clearly correct.[1]

1. Since the offset items were unquestionably "debts due to the United States," they would, in an action against the assignee, be entitled to priority over claims of other creditors (*Illinois ex rel. Gordon* v. *United States,* No. 749, Oct. 7, 1945, decided April 22, 1946; *United States* v. *Emory,* 314 U. S. 423), including claims secured by liens where such liens were not specific and perfected. See *United States* v. *Waddill Co.,* 323 U. S. 353, 355, and cases there cited. Assuming, as petitioners contend (Pet. 7–13), that the surety herein has an equitable lien upon the unpaid contract balances, the surety's claim could not prevail over that of the United States in an

[1] Petitioners have apparently abandoned their contention made in the court below (R. 64–66) that the General Accounting Office erred in deducting, as an expense incidental to the contractor's default, the rental paid for temporary quarters for post offices between the completion dates specified in the contracts and the actual dates of completion.

action against the assignee, since such a lien is neither specific nor perfected.[2]

The fact that in the instant case the Government's claim is asserted as an offset to the claim of petitioners, rather than in an original proceeding against the assignee, in no way alters the Government's right to priority. By permitting the offset, the court below not only obeys "the plain command of § 3466 that 'debts due to the United States shall be first satisfied' " (*United States* v. *Emory,* 314 U. S. 423, 426), but avoids " 'circuity of action, inconvenience, expense, consumption of the courts' time, and injustice' " (*Cherry Cotton Mills, Inc.* v. *United States,* No. 187, Oct. T. 1945, decided March 25, 1946). Moreover, the decision below is consistent with *United States* v. *National Surety Co.,* 254 U. S. 73, where this Court flatly rejected the contention of a surety that, having fulfilled the obligation of its bond, it was entitled, under R. S. 3468, to share in the bankrupt's assets equally with the Government.

[2] Petitioners also argue that "the surety is a party to the contract with the United States and has a legal right in addition to his equitable lien, to receive from the United States the balance of the contract price" (Pet. 13–16). But, as the court below observed (R. 69), "the agreement of the United States that the surety should become subrogated to its principal's rights against it must be understood to have been made subject to the limitation that the Government should nevertheless have the priority given it" by R. S. 3466. Cf. *United States* v. *Knott,* 298 U. S. 544, 547. Moreover, any agreement to waive R. S. 3466 would be beyond the authority of the contracting officer.

The fundamental error common to both the petition and the brief *amicus curiae*[3] is the failure to recognize that the unqualified command of R. S. 3466 cuts across the rights of a subrogee in the same manner as it supersedes other legal or equitable rights. Regardless of the rights normally accorded to a surety by the courts, such rights must yield to the plain command that in case of an assignment for the benefit of creditors, the "debts due to the United States shall be first satisfied." There is no reason why the right of the United States to preference here as against its debtor's surety should be any less than it was in *United States* v. *Knott,* 298 U. S. 544, as against the State Treasurer in possession of a trust fund; in *United States* v. *Emory,* 314 U. S. 423, as against wage claimants; in *United States* v. *Texas,* 314 U. S. 480, as against state gasoline tax liens; in *United States* v. *Waddill Co.,* 323 U. S. 353, as against a landlord's lien and a municipal tax lien; or in *Illinois ex rel. Gordon* v. *United States, supra,* as against a State's claim to unemployment compensation taxes.

Both petitioners and the *amicus* urge that R. S. 3466 cannot apply because the withheld money in the hands of the United States does not belong either to the assignee or to contractor, but constitutes a trust fund retained by the

[3] A brief *amicus curiae* in support of the petition has been filed by the Association of Casualty and Surety Executives.

United States for the benefit of the person found to be entitled thereto. But that was the precise argument rejected by the Court in *United States* v. *Knott,* 298 U. S. 544, 548–551. There a Florida statute required all surety companies doing business to deposit certain securities with the State Treasurer, who held the fund in trust for the protection and benefit of all Florida claimants against the depositing surety company. Under the state statute the United States was not a beneficiary of the trust fund (298 U. S. at 549). This Court held that the creation of the trust fund did not divest the surety company of title thereto and that, in the absence of a specific, perfected lien, the United States was entitled to priority in payment out of the fund.[4] We submit that the fund here retained by the United States differed in none of its essential aspects

[4] This Court said (298 U. S. at 550–551):

"Obviously, the deposit did not divest the company's title to the securities. No one was appointed trustee; and, at the time of the deposit, there was no ascertainable beneficiary. Who would share in the proceeds of the securities could not be known until they were exhausted in satisfaction of judgments, or until the entry of the decree of distribution in a suit authorized by the 1933 amendment. While in the case at bar the Supreme Court declared that the deposit created a 'trust fund,' the term appears to have been used to connote an inchoate general lien for the benefit of those persons who may become entitled to be paid from the proceeds, either as unsatisfied judgment creditors, or as Florida creditors at the time when insolvency supervenes. Such an interest lacks the characteristics of a specific perfected lien which alone bars the priority of the United States."

from the fund involved in the *Knott* case. Until the insolvency of the contractor occurred, the surety, at the best, had only an inchoate lien. Cf. *United States* v. *Waddill Co.*, 323 U. S. 353, 359.

Notwithstanding petitioner's assertion (Pet. 5, 8–9), there is no conflict between the decision below and *Maryland Casualty Company* v. *United States*, 100 C. Cls. 513. In the *Maryland Casualty* case, where the Government was denied the right to offset a tax claim against the balance due under the contract, in derogation of the surety's interest, the court below denied priority to the Government on the ground that there had been no formal insolvency, as is "evidenced by a bankruptcy, receivership, or assignment for the benefit of creditors" (100 C. Cls. 513, 518). In the instant case the insolvency of the contractors has been manifested in one of the ways required by the statutes, namely, by a formal assignment for the benefit of creditors (R. 32).

Both petitioners and the *amicus* apparently are confused as to the scope of the ruling of the court below. They assert conflicts with subrogation cases wherein the United States was asserting no priority under R. S. 3466 but was, at the best, a stakeholder,[5] *e. g. Prairie State Bank* v. *United*

[5] Contrary to the assertion of the brief *amicus curiae* (pp. 2–3), there is no conflict between the decision below and the decisions in *Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404; *Morgenthau* v. *Fidelity & De-*

States, 164 U. S. 227; they confuse cases in bankruptcy, where priority was denied the United States because of existing liens, with equity proceedings;[6] and they seek to establish the importance of the question here presented by urging that the ruling of the Court of Claims in *Maryland Casualty Company* v. *United States,* 100 C. Cls. 513, requires affirmance, although the question posed by that case is not here present.[7]

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posit Co., 94 F. 2d 632 (App. D. C.); and *Philadelphia National Bank* v. *McKinlay*, 72 F. 2d 89 (App. D. C.). In none of these cases was a claim asserted by the United States as against a claim of the surety, nor was R. S. 3466 involved.

[6] The petitioners cite (Pet. 11, 16–17, 19–20) a number of cases such as *United States F. & G. Company* v. *Sweeney*, 80 F. 2d 235 (C. C. A. 6), for the proposition that the subrogee of materialmen and wage earners takes priority over the claims of the United States for taxes. However, these cases have no significance in an equity proceeding. See Rogge, *The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships* (1929), 43 Harv. L. Rev. 251. Under Sec. 67 of the Bankruptcy Act (11 U. S. C. 107), a valid lien is superior to the trustee's title and the trustee takes subject to the lien. Accordingly, the order of priority fixed under Sec. 64a of the Bankruptcy Act (11 U. S. C. 104), which provides for the order of payment of the assets of the bankrupt estate, necessarily is junior to claims under existing liens.

[7] Petitioners and the brief *amicus curiae* heavily rely upon the refusal of the General Accounting Office to follow the doctrine of the *Maryland Casualty* case (Pet. 5–6; Br. 2–5). But that fact is obviously of no relevance here as it is not the doctrine of the *Maryland Casualty* case but an exception thereto that is here before this Court for review. If petitioners are dissatisfied with the action of the General Accounting Office in cases similar to the *Maryland Casualty* case, where there has been no formal act of insolvency, their

The mere statement of these contentions demonstrates their inapplicability to the present case.

CONCLUSION

The decision below is clearly correct and there is no conflict. It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

J. HOWARD MCGRATH,
Solicitor General.
JOHN F. SONNETT,
Assistant Attorney General.
PAUL A. SWEENEY,
JOSEPH B. GOLDMAN,
Attorneys.

AUGUST 1946.

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appropriate remedy is before the Court of Claims, which presumably will again apply the doctrine of the *Maryland Casualty* case in such situations.

APPENDIX

1. Rev. Stat. 3466, 31 U. S. C. 191, provides as follows:

> *Priority established.*—Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

2. Section 1 of the Act of August 24, 1935, c. 642, 49 Stat. 793, 40 U. S. C. 270a, provides in part as follows:

> (a) Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as "contractor":
>
> (1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as

he shall deem adequate, for the protection of the United States.

(2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person. Whenever the total amount payable by the terms of the contract shall be not more than $1,000,000 the said payment bond shall be in a sum of one-half the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $1,000,000 and not more than $5,000,000, the said payment bond shall be in a sum of 40 per centum of the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $5,000,000 the said payment bond shall be in the sum of $2,500,000.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 244.

DEWEY SCHMOLL, Successor Assignee For Benefit of Creditors of Murch Bros. Construction Co., and NATIONAL SURETY CORPORATION, *Petitioners,*

v.

THE UNITED STATES.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI ON BEHALF OF ASSOCIATION OF CASUALTY AND SURETY EXECUTIVES, AMICUS CURIAE.

ALEXANDER M. HERON,
Attorney for the Association of Casualty and Surety Executives, Amicus Curiae.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 244.

DEWEY SCHMOLL, Successor Assignee For Benefit of Creditors of Murch Bros. Construction Co., and NATIONAL SURETY CORPORATION, *Petitioners*,

v.

THE UNITED STATES.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI ON BEHALF OF ASSOCIATION OF CASUALTY AND SURETY EXECUTIVES, AMICUS CURIAE.

INTRODUCTION.

This brief is filed on behalf of the Association of Casualty and Surety Executives, an association composed of sixty-six member corporations of which fifty-five engage in the business of becoming sureties. Fifty-four of these members are qualified to become sureties on bonds accepted by the United States and compose the majority of the ninety-six corporate sureties whose bonds are acceptable to the United States according to the semi-annual statement of the Treasury Department issued April 29, 1946.

PURPOSE OF THE BRIEF.

It is the purpose of the brief to draw attention to the importance of obtaining an authoritative decision upon the question presented in this litigation and especially the application of Section 3466 of the Revised Statutes, 31 U. S. C. A. 191, Act of March 3, 1797, Ch. 20, P. 5, 1 Stat. 515, 9 F. C. A., Title 31 P. 191 to the facts here disclosed. Increasingly numerous contests, some of which are now in the General Accounting Office and some in the Court of Claims, are arising between the United States and sureties whose bonds they hold with respect to the making of set-offs by the former out of contract balances which would otherwise be available to the sureties for their exoneration and indemnity. The question is one which has not, but should be decided by this Court.

The decision of the court below is in conflict with all of those cases in the Circuit Courts of Appeal, illustrated by *Philadelphia National Bank* v. *McKinlay,* 72 F. (2d) 89, 63 App. D. C. 296 (1934) and *Morgenthau* v. *Fidelity & Deposit Co.,* 94 F. (2d) 632, 68 App. D. C. 163 (1937) in which it has been held that the United States hold the unexpended contract balance as an earmarked fund for the benefit of the furnishers of labor and material to the exclusion of all creditors of the contractor. The decision of the Court below permits the invasion of this fund by the United States for the satisfaction of its collateral claims which have no relation to the trust. It is in conflict with the decision of this Court in *Henningsen* v. *United States Fidelity & Guaranty Co.,* 208 U. S. 404 (1908) to the extent that it denies the surety's right of subrogation in favor of independent claims of the United States as a creditor of the contractor and to the extent that it treats the funds in the hands of the United States as assets of the contractor notwithstanding his default in the performance of the work and his failure to pay labor and material claims.

The Comptroller General and the General Accounting Office have taken the position that the United States may

maintain the right of set-off in every case without regard to whether or not the surety has sustained a loss under its bond by reason of having completed the work or paid labor and material bills. The Court of Claims has denied the right of set-off in such cases when there was no proof of formal insolvency of the contractor. But in the case at bar, although the surety had sustained a loss by reason of having been required to pay labor and material bills, the claim of the United States to the right of set-off was allowed by the Court of Claims because it appeared that the contractor had made an assignment for the benefit of creditors. The Court, however, in allowing such set-off stated specifically that it was not deciding whether or not the same ruling would apply to a surety on a performance bond, or in other words, to a situation where the surety had sustained its loss as a result of having completed the work.

The General Accounting Office has declined to be guided by the principles laid down by the Court of Claims and has taken the position that it will continue to make the set-offs in the absence of an authoritative decision by this Court with respect to the precise question involved. It has disregarded the principles of the Henningsen case, supra, as well as decisions of the lower Federal courts. As a consequence, the subject is in confusion.[1]

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[1] The General Accounting Office follows the practice of setting off independent claims against contract balances regardless of whether the surety completed the work, *U. S. Fidelity & Guaranty Co.* v. *United States,* 92 C. Cls. 144, 148-149 (1940), or whether it had paid material bills, *Maryland Casualty Company* v. *United States,* 100 C. Cls. 513, 516 (1944). Subsequent to those decisions the Comptroller General ruled on July 14, 1944, in decision No. B-17988 (not officially reported) that:

> "Accordingly, and in the absence of a contrary ruling by the Supreme Court of the United States, the Maryland case may not be accepted to change or modify the long standing view of this office that the right of the United States to have its debts first satisfied from funds earned by a contractor is paramount to the right of a surety asserting a loss in making pay-

SUMMARY OF FACTS.

Between 1933 and 1935 the United States entered into over 17 contracts with Murch Brothers Company, Inc., a contractor, for the construction or remodelling of various post office buildings (R. 32-33). In pursuance of the provisions of the Act of August 13, 1894, C. 280, 28 Stat. 278; Feb. 24, 1905, C. 778, 33 Stat. 811; Mar. 3, 1911, C. 231, ¶291, 36 Stat. 1167, 40 U. S. C. A. 270 the National Surety Corporation became surety upon bonds[2] of the contractor given to the United States to secure the payment of labor

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ment of the claims of materialmen and laborers, and the action heretofore taken in the matter must be, and is, affirmed."

The same policy was again reiterated on April 18, 1946, when it was said:

> "What was said in the above-quoted decisions relative to the decisions of the Court of Claims is especially appropriate to the present matter of the holding of that court in the *Maryland Casualty Company case.* And while careful consideration has been given to the matters advanced by you in support of the contention that this office should regard the ruling in that case as a controlling precedent in the settlement of the instant claim, it must be concluded, in the absence of an authoritative decision by the Supreme Court of the United States with respect to the precise question involved, that the *Maryland Casualty Company case* may not be accepted to change or modify the long standing view of this office that the right of the United States to have its debts first satisfied from funds earned by a defaulting contractor is paramount to the right of a surety asserting a loss in completing the defaulted contract." B-41334 (Not officially reported).

In re Van Winkle, 49 Fed. Supp. 711 (D. C. Ky.-1943) and *American Surety Co. of New York* v. *City of Louisville M. H. Comm.*, 63 Fed. Supp. 486 (D. C. Ky.-1945) both hold the surety's right to such funds to be superior to claims of the United States.

[2] The bonds given here join in a single instrument the dual obligation that the contract be performed and payment be made for labor and material. A subsequent enactment, Act of August 24, 1935 C. 642 pp. 1-4, 49 Stat. 793-4, 40 U. S. C. A. 270 a-d. provides for two bonds, one guaranteeing performance of the contract and the other payment for labor and material. The changes effected were designed to eliminate procedural difficulties which had arisen under the earlier Act. The substance of the law remains unchanged.

and material furnishers and the performance of the work under 17 of these contracts (R. 34).

By June of 1935 the contractor had performed a large part of the work required under its contracts; but during that month, because of lack of funds and its inability to secure more, it became unable either to pay for labor and material which had been furnished it, or to complete the work. Thereupon the United States terminated the contractor's right to proceed with the work remaining to be done and proceeded to have it completed (R. 34-35). In some instances the cost of completion was less than the unpaid balance of the original contracts, while in other instances such cost exceeded the unpaid balances (R. 35-36).

Subsequent to the termination of the contractor's right to proceed with the work, persons who had furnished labor and material for use under various of the 17 contracts made claim upon the surety for payment therefor as required by the latter's bonds. The surety responded by making payments to such labor and material-men in the total amount of $202,011.66. In every instance where the total cost of completion was less than the contract balance which remained at the time of the contractor's default, the surety paid labor and material claims appreciably exceeding the surplus thus established (R. 38-46).

In all instances where the cost of completion by the United States exceeded the unexpended contract balances, thus raising charges against the contractor and its surety, those charges were satisfied by setting them off against the surplus monies remaining under the contracts which were completed by the United States for less than the balances on hand (R. 47-48). But after these charges were satisfied, there still remained in the hands of the United States a balance of $22,505.01 allocable to contracts (R. 47-48) in connection with which the surety had paid labor and material bills to the extent of $100,444.17 (R. 38, 39, 40, 41, 42-43).

The United States had assessed a capital stock tax against the contractor for the year 1935 in the amount of $206.53 (R.

47). Under two other contracts entered into between Veterans Administration and the contractor, charges for defective work had accumulated against the contractor in the amount of $2,552.43. With these contracts the surety had no connection whatsoever. (R. 46-47) The General Accounting Office undertook to set off these unrelated items against the balances allocable to contracts which the surety had bonded and on account of which it had been obliged to make payments (R. 46-47). The Court below, while awarding the remaining balance to the surety, upheld the off-set of these unrelated items against the contract balances (R. 66-69). The right of the United States to off-set these two unrelated and collateral items is the subject of the controversy here sought to be settled and clarified.

The contractor executed an assignment for the benefit of its creditors pursuant to which the original plaintiff in the court below was appointed assignee on January 3, 1936 (R. 32), or approximately six months after default had resulted in termination of the various contracts upon which the surety was obligated (R. 34).

ARGUMENT.

The Surety's Rights Are Contractual.

The failure of the contractor to pay its bills for labor and material constituted a breach of contract. In *Martin* v. *National Surety Company*, 300 U. S. 588 (1937), it was said that:

> "* * * the statute directs that a bond for the prompt payment of materialmen and laborers shall be executed by the contractor before the commencement of the work. Not only that, but the contract with the Government, which was drawn in the standard form, is a confirmation and adoption of the statutory duty. The terms of the bond are read into the contract, and there is default under the contract when there is default under the bond."

As a consequence of this default, as well as the contractor's failure to continue with the work, it forfeited its rights to receive payment under the several contracts. It is certain that neither the contractor nor his assignee was entitled to maintain any claim to the contract proceeds before the work was complete; and similarly, until the labor and material claims were paid, the contractor and his assignee remain in the same position, *Philadelphia National Bank* v. *McKinlay, supra.* The contract balances were used for the completion of the work and they should be equally available for the payment of labor and material bills. The surety, which has only a secondary liability for both completion and payment of labor and material bills, is entitled to insist upon the use of the contract balances to remedy both defaults under the contract. There is neither reason nor logic in allowing the balances to be used for the repair of one default and diverting them from the payment of the other default. If the decision of the Court below is correct, it would be equally logical to require that the surety complete the work as well as pay labor and material bills, while the United States absorbed the entire unexpended contract balance in liquidation of independent claims which they held against the contractor.

Since the failure to pay labor and materialmen constituted a breach of the contract, the United States had the right to withhold contract payments until the breach was remedied. The United States did, in fact, withhold payment of the contract balances after the time of the contractor's default. Under these circumstances the diversion of the contract payments to the satisfaction of other debts of the United States would amount to a departure from the contract terms which in itself might release the surety from the obligation of its bonds. The surety does not ask to be released; it has met the obligations of its bonds. It has insisted that there be adherence to the original terms of the contract and that the United States recognize its right to reimbursement for

its losses—a right which accrued to it as a consequence of its entering into the transaction.

That the diversion of the contract funds amounts to a breach of the contract is further demonstrated by the rule which releases the surety where the party secured makes a material departure from the terms of the contract, the performance of which the surety bonded. It is inescapable in the present instance that the true intendment of the parties was that the contract price should pay for the completed building and all the labor and material in it. This is further emphasized by the provision for payment as the work progressed (R. 19) which was obviously designed to enable the contractor to pay such bills during the course of the work.

The surety is entitled to stand upon the precise terms of its contract.

> "Nothing can be clearer, both upon principle and authority, than the doctrine that the liability of a surety is not to be extended, by implication, beyond the terms of his contract. To the extent, and in the manner, and under the circumstances pointed out in his obligation, he is bound, and no farther. It is not sufficient that he may sustain no injury by a change in the contract, or that it may even be for his benefit. He has a right to stand upon the very terms of his contract; and if he does not assent to any variation of it, and a variation is made, it is fatal." Per Mr. Justice Story, *Miller* v. *Stewart*, 9 Wheat. 680.

The practical effect of what has been done by the Court below is that the surety is required to pay the unrelated charges for taxes and defective work out of funds which the whole transaction intended should be for its benefit. The Court of Claims recognized the absurdity of this result when it said with reference to the surety in *Maryland Casualty Co.* v. *U. S.*, 100 C. Cls. 513, 521:

> "But we do not think that it intends, or is expected by the Government or the other contracting party to take the risk that any part, or perhaps the whole, of the contract price which by the contract the Government

promises to pay upon performance, will be "paid", not in money but by a bookkeeping process of crediting these sums against taxes or other debts of the contractor not related to the contract, to the prejudice of the surety."

Equity Recognizes and Enforces an Ownership of the Fund in Favor of the Surety.

In *Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404 (1908) the contractor had completed the building but failed to pay labor and material furnishers. The latter were paid by the surety pursuant to the bond given under the same statute as here. Thereupon a contest ensued between the surety and the contractor's assignee for the balance of the contract price. This Court held that the surety was entitled to subrogation and as a consequence to be reimbursed for the payments which it had made. It was said:

> "The guaranty company was surety on that contract. Its stipulation was not merely that the contractor should construct the buildings, but that he should pay promptly and in full all persons supplying labor and material in the prosecution of the work contracted for. He did not make this payment, and the guaranty company, as surety, was compelled to and did make the payment. Is its equity superior to that of one who simply loaned money to the contractor, to be by him used as he saw fit, either in the performance of his building contract or in any other way? We think it is. It paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the government from all equitable obligations to see that the laborers and supplymen were paid. It did this not as a volunteer, but by reason of contract obligations entered into before the commencement of the work."

The application of this doctrine to construction contracts of the United States stems from *Prairie State National Bank* v. *United States*, 164 U. S. 227 (1896). There the con-

tractor defaulted and the surety completed the work. It was held that the surety was entitled to subrogation to the rights of the United States and that its subrogation must be considered as arising from and relating back to the date of the original contract. It was held that the surety became entitled to resort to the securities and remedies which the United States were capable of asserting against the contractor and that one of such remedies was the right, based upon the original contract, to appropriate the monies retained for the reduction of the damage. This Court said at page 233:

> "That a stipulation in a building contract for the retention, until the completion of the work, of a certain portion of the consideration, is as much for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; that it raises an equity in the surety in the fund to be created; and that a disregard of such stipulation by the voluntary act of the creditor operates to release the sureties, is amply sustained by authority."

In *Belknap Hardware Mfg. Co.* v. *Ohio River, Etc. Company*, 271 Fed. 144 (C. C. A. 6th—1921) it was said with reference to *Henningsen* v. *United States Fidelity & Guaranty Co., supra:*

> "Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated. This is not stated in the opinion in very express terms, but it had been pressed upon the court (208 U. S. 407, 408, 28 Sup. Ct. 389, 52 L. Ed. 547) that there could be no such subrogation without such a right, and that there was no such right. On page 410, of 208 U. S., on page 391 of 28 Sup. Ct. (52 L. Ed. 547), the court refers to and assumes that the Government, after the bond was given was still charged with 'equitable obligations to see that

the laborers and supply men were paid.' We are constrained to think that the decision necessarily rests upon the existence of this right, as one entitling these claimants to priority in payment out of the fund, and therefore as entitling the surety, as their equitable assignee by subrogation, to the same priority."

See also:

Hardaway v. *National Surety Co.*, 211 U. S. 552 (1909)
In re Scofield Co., 215 Fed. 45 (C. C. A. 2d—1914)
American Bonding Co. v. *Central Trust Co.*, 240 Fed. 400 (C. C. A. 7th—1917)

In another instance where a surety sought to recover from a bank the proceeds of a contract entered into by a contractor, Anderson, and the United States, the court said:

"Thus, in consequence of Anderson's default, the $37,170.04 then in the hands of the United States became a fund which the United States was entitled to apply to the payment of materialmen's claims, and which appellee, as subrogee of the United States, was entitled to have applied in reimbursement of the $21,609.28 expended by it in paying such claims; and appellee's right to have the fund so applied was superior to any right of Anderson or Anderson's assignees—if any." *California Bank* v. *U. S. F. & G. Co.*, 129 F. (2d) 751 (C. C. A. 9th—1942).

The general rule on this subject is stated in *Hayes* v. *Ward*, 4 Johns. Ch. (N. Y.) 123 by Chancellor Kent to be:

"* * * a surety will be entitled to every remedy which the creditor has against the principal debtor, to enforce every security, and to stand in place of the creditor and to have his securities transferred to him, and to avail himself of those securities against the debtor."

The Court below has recognized the application of this proposition in *United States Fidelity & Guaranty Co.* v. *United States*, 92 C. Cls. 144 (1940) and in *Maryland Casu-*

alty Company v. *United States*, 100 C. Cls. 513 (1
well as that enunciated in *Henningsen* v. *United St*
delity & Guaranty Company, supra, but has conclu
the insolvency of the contractor within the meaning
3466 compels a different result.

As early as 1898 the courts had viewed the claims
nishers of labor and material as having the pos
special liens:

> "The practical effect of the statute is to
> special lien in favor of such persons and to s
> this bond, in the place of the public building
> thing upon which that lien is charged." *Mar*
> *pany* v. *Burgdorf*, 13 App. D. C. 506, 519 (189

The same court subsequently, in *Richards Bric*
Rothwell, 18 App. D. C. 516, 537 (1901) said:

> "There is, therefore, by necessary implica
> equitable lien and preference secured in favo
> parties who furnish labor and materials in th
> tion of the contract, in the application or distri
> the contract price remaining to be paid; an
> the government, as in the present instance, ho
> hands any part of the money contracted to be
> the work, and there remain unpaid claims for la
> materials supplied, it holds such fund as quas
> for the benefit of those entitled to receive it u
> condition in the bond; that is so say, the labo
> materialmen remaining unpaid. This right ter
> ence being the result of the operation of the stat
> the condition of the bond, it is the clear right, h
> plainest principles of justice, of the sureties in
> to invoke a court of equity to enforce the pro
> and equitable lien for their protection. In con
> this act of Congress of 13th August, 1894, thi
> said, in the case of *Marble Company* v. *Burg*
> App. D. C. 506, 519 (1898):
>
> > 'The practical effect of the statute is to
> > special lien in favor of such persons (parties
> > ing labor and materials) and to substitute

in the place of the public building, as the thing upon which that lien is charged.'

"That is to say, the bond is liable rather than the building upon which labor and materials are used in construction; and if the sureties should pay claims for such labor and materials for which they may be responsible on the bond, they have a right, upon well-settled principles, of substitution to such claims as against the contract price of the work remaining due to the contractor. And having such right of substitution, the sureties have a right to interpose to prevent the diversion or misapplication of the fund, and to require it to be paid out to the parties entitled to receive it in the first instance by virtue of the lien and preference given by operation of the statute."

The Surety's Rights Are Not Affected by R. S. 3466.

R. S. 3466 accords the United States no more than a priority in the assets of the debtor. R. S. 3466 does not give the United States priority in assets which do not belong to its debtor. In cases where contract funds were in the hands of the owner, and impressed with the rights of the surety who had paid labor and material claims, the surety's rights have been recognized as paramount to those of the contractor, and as a consequence as paramount to claims of the United States against the contractor. This has been done on the stated notion that the rights of the United States could rise no higher than the rights of its debtor.

United States Fidelity & Guaranty Co. v. *Triborough Bridge Authority*, 48 N. Y. S. (2d) 16 (1944)
Karno-Smith Co. v. *Maloney*, 112 F. (2d) 690 (C. C. A. 3d—1940)
F. H. McGraw Co. v. *Sherman Plastering Co., Inc.*, 60 F. Supp. 504 (D. C. Conn.—1943)
See also *In re Heintzelman*, 34 F. Supp. 109 (D. C. N. Y.—1940)

In the case at bar the principles are the same, and no difference in result is warranted by the fact that the funds are in the possession of the United States.

The cases which have dealt with the application of R. S. 3466 are cases involving the distribution of assets in some legal proceeding undertaken for that purpose. They are cases such as *United States* v. *Waddill, Holland & Flinn,* 323 U. S. 353 (1945), and *United States* v. *Emory,* 314 U. S. 423 (1941). In none of those cases has it been held that the priority accorded to the United States extended to assets as to which the interests of the debtor had been displaced and subordinated prior to the institution of the proceedings, and which were not and could not be administered in the insolvency proceedings, because the debtor, his assignee or receiver could not collect them over the claim of the surety. In none of the cases dealing with the application of R. S. 3466 has it been held that the United States may assert a claim to funds which as a consequence of its own contract with the surety are payable to the latter for the reimbursement of its expenditures either in completing the work or paying labor and material bills. Particularly should this be true where, as here, the claimed off-sets are unrelated to the bonded contracts which produced the funds involved.

The defaults under the contracts in the case at bar occurred in June, 1935 (R. 34). The rights of the surety to exoneration and subrogation came into operation at that time. Those rights relate back to the date of the original contract, *Prairie State National Bank* v. *United States,* 164 U. S. 227, 232 (1896). The incidence of the contractor's insolvency established by an assignment for the benefit of creditors six months later should not be permitted to oust the rights acquired long previously by operation of law.

CONCLUSION.

The uncertainty which now exists as to the application of R. S. 3466 to the situation in the case at bar as well as the confusion enveloping the subject generally as a consequence of the conflicting views of the General Accounting Office and the courts should be settled by a decision of this Court. The decision of the Court below is in error in sustaining a right

of set-off against the fund which both by contract and equity belongs to the surety. It is submitted that the application for the writ should be granted.

Respectfully,

ALEXANDER M. HERON,
Attorney for the Association of Casualty and Surety Executives, Amicus Curiae.